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Wealth Planning Update

Titling Real Assets: Advantages and Disadvantages

AUGUST 2019

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Key takeaways:

- Establishing an entity to hold real assets (mineral interests, commercial real estate, and residential properties) can be an effective way to potentially mitigate liability risk, consolidate assets, and create a platform for potentially transferring ownership in an estate in a tax-efficient manner. There are possible downsides as well that you should carefully consider before taking the next step.

What this may mean for you:

- To determine the best approach for your specific situation, make sure you discuss your plans with your attorney and advisors.

With proper due diligence, the returns on investments in real assets, such as mineral interests, commercial real estate, and residential investment properties may outpace returns from investing in the stock market. Coupled with the cash flow from royalties or net rental income, these investments can be a lucrative source to build wealth. Many investors like the tangible nature of these investments, but careful consideration should be given to the proper ownership structure for real assets.

This update outlines key considerations, advantages, and disadvantages of holding real assets in an individual's name versus in an entity, such as a limited liability company, limited partnership, or corporation.

Key entity considerations

There are several factors to consider in establishing an entity to hold an asset (investment property, real estate, mineral rights, etc.):

- **Where the entities are established (in state vs. out of state).** Certain states have more favorable creditor protection laws around certain entity formation.
- **Which asset(s) are being placed in the entity.** Establishing multiple entities to mitigate creditor risk is very common.
- **Tax considerations for the entity.** For example, LLC owners can choose to be taxed as a partnership, S Corporation, or C Corporation (or disregarded entity for federal tax purposes, if one owner). Certain provisions also apply to a husband and wife in community property states (for example, they can treat the entity as a disregarded entity for federal tax purposes).

When considering these issues, it is key to work with a knowledgeable attorney while also building a detailed operating agreement. Furthermore, you should work with a specialized property and casualty insurance professional to review the asset(s) and the entity to verify proper coverage is in place. This insurance should be coordinated with the broader assets of the individual and family.

Potential advantages of forming an entity for real assets

So why might it be beneficial to form an entity to hold real assets rather than owning those assets individually (or jointly)?

- Asset protection—Holding real assets within an entity allows the owner to isolate the liability associated with the asset, thus helping protect the individual's other assets owned in their own name from judgements or claims against the entity.
    - Real estate investors, both commercial and residential, may consider owning each real estate investment in a separate entity, thereby helping protect the majority of holdings when there is lawsuit or other liability related to one asset.
    - In regard to mineral interests, owners may consider transferring ownership of working interests into their own entity, separate from royalty interests. This will help keep the investor's other assets from being part of a lawsuit should there be a claim against the working interests.

- Formalization of management—Using an entity allows for formalization of the entity both during the life of the investor as well as upon his or her death.
    - When organizational documents are drafted properly, entities can help in formalizing a plan for continued management and include provisions to account for an interest owner's death or disability.

- Efficient manner of transferring ownership—Assets residing in entities can be transferred to others such as family members, either outright or in a trust, in an estate-tax- and gift-tax-efficient manner.
    - When an interest in an entity is transferred, whether by gift or sale during the interest owner's life or upon the interest owner's passing, a qualified appraisal should be completed.
    - If family assets are consolidated within an entity and a transfer, whether by gift or sale, occurs to another family member, only the interest in the entity being transferred will need to be retitled since it is a change of ownership in the entity, not each subsequent asset owned within the entity.

    - If the same assets were to be transferred but were not owned in an entity, each individual asset would need to be retitled in the name of the new owner.
- Privacy—Using an entity to own assets rather than in an individual's own name can provide a layer of privacy.
    - Anyone seeking to find information on the ownership assets of an individual, such as real estate or mineral interests, will see only the name of the entity.
    - The interests can also be owned in the name of an individual's revocable living trust. This can provide an additional layer of privacy, avoid probate (which also can be accessible to the public), and account for the individual's proper estate planning.

Potential disadvantages of using an entity for real assets

- **Initial setup costs and ongoing expenses.** Forming an entity requires legal documents that will need to be drafted by an attorney and will incur associated fees, such as updating the record deeds and entity management costs.
- **Proper implementation of the entities.** Mistakes when creating the entity puts both the protection of the asset and the proper asset transfer via estate or lifetime gifting at risk.
- **Appraisal costs**. If an entity owner wants to transfer his or her interest to someone else during their lifetime, a qualified appraisal will need to be completed. The value derived through this qualified appraisal will be used to report the gift or sale to the IRS.

Summary

Establishing entities to hold real assets can be an effective way to mitigate liability risk, consolidate assets for ease of management, and create a platform for potentially transferring ownership in an estate in an efficient manner. However, the proper implementation of an entity is extremely important. Any mistakes with the creation and funding of the entity could jeopardize the asset protection characteristics as well as expose the individual to potential estate- and gift-tax consequences. For more information on utilizing an entity for real assets, contact a Wells Fargo relationship manager.

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